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Accounting for dollar repurchase, dollar reverse repurchase agreements by sellers-borrowers : amendment to AICPA audit and accounting guide, Savings and loan associations; Statement of position 85-2;

American Institute of Certified Public Accountants. Accounting Standards Division

Statement of Position

85-2

Accounting for Dollar Repurchase–Dollar Reverse Repurchase Agreements by Sellers-Borrowers

January 1, 1985

Amendment to
AICPA Audit and Accounting Guide
Savings and Loan Associations

Issued by
Accounting Standards Division

American Institute of
Certified Public Accountants

AICPA

NOTE

This statement of position significantly amends the AICPA Audit and Accounting Guide, *Savings and Loan Associations,* and provides recommendations on accounting principles for dollar repurchase–dollar reverse repurchase agreements by sellers-borrowers for transactions entered into after December 31, 1984.

Statements of position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statements of position do not establish standards enforceable under rule 203 of the AICPA Code of Professional Ethics. However, Statement on Auditing Standards (SAS) No. 5, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report,* as amended by SAS No. 43, *Omnibus Statement on Auditing Standards,* identifies AICPA statements of position as another source of established accounting principles the auditor should consider. Accordingly, members should be prepared to justify departures from the recommendations in this statement of position.

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Introduction

1. Mortgage financing that is normally collateralized by residential property is generally originated by financial institutions (mortgagees) directly with the purchasers (mortgagors) of the real estate and is referred to as the primary mortgage market. Direct investment in the primary mortgage market by financial institutions, such as savings and loan associations (S&Ls), banks, mortgage banks, and credit unions, may not result in efficient channeling of funds to the housing market because of regional disparities in the supply of and demand for mortgage funds. Consequently, a secondary mortgage market was created through government-related agencies to eliminate regional disparities and provide additional mortgage funds in areas where demand exceeds supply.

2. The Government National Mortgage Association (GNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) have participated in the development and widespread adoption of mortgage-backed securities as a means of financing home loans. Since 1970, the U.S. government has guaranteed, under GNMA sponsorship, timely payments of principal and interest on securities that are issued by private financial institutions and backed by pools of government-insured or government-guaranteed mortgages. GNMA pass-through securities provide for monthly installments of interest on the unpaid balance at the securities' stated certificate rate plus payment of scheduled principal amortization, regardless of the delinquency status of the underlying collateral, together with any prepayment or other recoveries of principal. GNMA pass-through securities are issued by mortgage bankers, S&Ls, and banks that originate FHA-VA mortgages. Instead of selling the mortgages outright or financing them through deposits or other debt, the issuer forms a pool of mortgages, and sells pass-through securities. The issuer collects the mortgage payments and after deducting servicing fees, remits monthly to the certificate holders.

3. Created by Congress in 1970, the FHLMC has as its primary objective the development of a national secondary market in conventional mortgages. Generally, the FHLMC purchases conventional mortgage loans from financial institutions whose deposits are insured by a U.S. government agency. In 1974, it began to sell mortgage participation certificates, which are similar to GNMA pass-through securities, although they are not backed by the full faith and credit of either the U.S. government or the Federal Home Loan Banks. These certificates represent ownership interest in pools of conventional mortgages purchased by the FHLMC. The FHLMC guarantees the monthly pass-through of interest, scheduled amortization of principal, and ultimate repayment of principal. Participation certificates are marketed directly by the FHLMC and by a group of securities dealers who also maintain a secondary market in seasoned issues.

4. GNMA pass-through securities and FHLMC participation certificates are bought and sold in a variety of arrangements, including repurchase–reverse repurchase agreements and dollar repurchase–dollar reverse repurchase agreements.

5. A repurchase–reverse repurchase agreement is an agreement (contract) to sell and repurchase or to purchase and sell back identical certificates within a specified time at a specified price.[1] These transactions are equivalent to borrowing and lending funds equal to the sales price of the related certificates. For example, if an S&L wants to borrow funds with securities as collateral, it may, instead of borrowing, arrange to temporarily sell its certificates with an agreement to repurchase them on a future date at a specified price. A difference in price represents interest for use of the funds.

6. Banks and broker-dealers refer to agreements to sell and repurchase as "repurchase agreements." S&Ls call these same agreements "reverse repurchase agreements." Similarly, banks and broker-dealers call agreements to purchase and subsequently sell securities "reverse repurchase agreements," while S&Ls call such transactions "repurchase agreements." The following illustrates the use of those terms.

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[1]For purposes of this statement, the term *certificates* refers only to GNMA pass-through certificates and FHLMC participation certificates. Certain financial institutions, such as S&Ls, consider these certificates investments in real estate loans, while others, such as banks and broker-dealers, consider them to be investments or trading securities.

- A broker-dealer enters into a contract with another broker-dealer to sell and subsequently repurchase the same security. The broker-dealer that sells and repurchases the security calls it a repurchase agreement. The broker-dealer that buys and sells back the security calls it a reverse repurchase agreement.

- An S&L enters into a contract with another S&L to sell and subsequently repurchase the same security. The S&L that sells and repurchases the security calls it a reverse repurchase agreement. The S&L that buys and sells back the security calls it a repurchase agreement.
- An S&L enters into a contract with a bank or broker-dealer to sell and subsequently repurchase the same security. The S&L calls it a reverse repurchase agreement and the bank or broker-dealer also calls it a reverse repurchase agreement.

7. Repurchase–reverse repurchase agreements involve identical securities, and the substance of the transactions is to borrow and lend funds. Dollar repurchase–dollar reverse repurchase agreements involve similar but not identical securities. The terms of the agreements often provide data to determine whether the securities are similar enough to make the transaction in substance a borrowing and lending of funds or whether the securities are so dissimilar that the transaction is a sale and purchase of securities. However, in agreements involving certificates collateralized by dissimilar pools, these transactions would be accounted for as sales and purchases. Due to the increasing complexity and volume of dollar repurchase–dollar reverse repurchase transactions, accounting treatment by the seller-borrower has become increasingly controversial.

8. A dollar repurchase–dollar reverse repurchase agreement is an agreement (contract) to sell and repurchase or to purchase and sell back certificates of the same agency but not the original certificates. Fixed coupon and yield maintenance dollar agreements comprise the most common agreement variations. In a fixed coupon agreement, the seller and buyer agree that delivery will be made with certificates having the same stated interest rate as the interest rate stated on the certificates sold. In a yield maintenance agreement, the parties agree that delivery will be made with certificates that will provide the seller a yield that is specified in the agreement. Distinguishing characteristics of each variation are summarized below.

Fixed Coupon	***Yield Maintenance***
Certificates sold back or delivered bear the identical contract interest rate and similar maturities as the original certificates.	Certificates sold back or delivered may bear a different contract interest rate from the original certificates.
Certificates collateralized by a similar pool of mortgages, such as single-family residential mortgages, and bearing the same contract interest rate are generally priced to result in substantially the same yield.	Certificates collateralized by a similar pool of mortgages but bearing a different contract interest rate are not priced to result in substantially the same yield.
	The price spread relationship between certificates with different contract interest rates does not move in tandem. The existence of yield and price disparities provides opportunities for the purchaser to deliver, within the terms of the agreement, certificates providing the greatest benefit to the purchaser.
Fixed coupon agreements do not contain "par cap" provisions.[2]	A yield maintenance agreement may contain a "par cap" provision that could significantly alter the economics of the transaction.
Seller-borrower retains control over the future economic benefits relating to the certificate transferred and assumes no additional market risk.	Seller-borrower surrenders control over the future economic benefits relating to the certificate transferred and assumes additional market risk.

9. Believing it desirable to reduce alternative practices in accounting for these agreements, the Accounting Standards Division of the American Institute of Certified Public Accountants has

[2] A *par cap* is a provision in some yield maintenance agreements limiting the repurchase price to a stipulated percentage of the face amount of the certificate.

prepared this statement of position to clarify the accounting for the sale of securities or borrowing of funds under dollar agreements.

Scope

10. This statement of position applies to accounting for the sale and purchase of securities or borrowing of funds by a fixed coupon or yield maintenance dollar agreement. The recommendations in this statement are limited to transactions involving only GNMA pass-through certificates and FHLMC mortgage participation certificates that the seller-borrower has owned and held in its portfolio for a reasonable period of time, for example, thirty-five days. The recommendations in this statement do not apply to forward placement or delayed delivery contracts for GNMA pass-through certificates or FHLMC mortgage participation certificates or a series of contracts that have the effect of such contracts.[3] This statement of position also applies to loans of those certificates if the loans are made under a fixed coupon or yield maintenance dollar agreement. This statement of position does not address accounting and reporting by the purchaser-lender.

11. This statement of position does not supersede existing accounting principles for other types of repurchase–reverse repurchase transactions as set forth in AICPA audit and accounting guides and statements of position.

12. This statement of position sets forth the division's conclusions on —

- Accounting for sales and purchases of or borrowing of funds through GNMA pass-through certificates and FHLMC participation certificates under fixed coupon and yield maintenance dollar agreements.
- Accounting for rollovers and extensions of original agreements.
- Accounting for the repurchase of a principal amount different from the principal amount of the original agreement.

[3]Accounting for forward placement or delayed delivery contracts is not discussed in this statement of position. An AICPA issues paper, "Accounting for Forward Placement and Standby Commitments and Interest Rate Futures Contracts," was sent to the FASB in December 1980.

Present Accounting Practices

Repurchase–Reverse Repurchase Agreements

13. The 1979 AICPA Audit and Accounting Guide, *Savings and Loan Associations,* addresses repurchases, commonly referred to as *repos*, and concludes that they "represent purchases of securities on a short-term basis under agreements whose terms provide that the sellers will repurchase the securities within a very short period of time, usually a few days." The S&L guide also concludes that —

> In substance, (reverse repurchases or reverse repos) represent borrowings collateralized by the related securities. When funds are borrowed under this (type of) arrangement, a liability should be established for the amount of the proceeds. The investment security account should not be relieved of the collateral securities. Interest on reverse repos should be reported as an expense and not shown net of interest income.

14. The guidance provided in the S&L guide regarding reverse repurchases is consistent with Statement of Financial Accounting Standards (SFAS) No. 65, *Accounting for Certain Mortgage Banking Activities,* paragraph 8, which states —

> Mortgage loans and mortgage-backed securities held for sale that are transferred under formal or informal repurchase agreements of the nature described in this paragraph shall (1) be accounted for as collateralized financing arrangements and (2) continue to be reported by the transferor as being held for sale.

Formal and informal agreements are characterized in SFAS No. 65 as those where the risk of market loss is retained by the mortgage banking enterprise. Further support is provided in the AICPA Audit and Accounting Guide, *Audits of Brokers and Dealers in Securities,* which discusses broker-dealer repurchase transactions. The broker-dealer guide defines a repurchase transaction as "a sale of a security coupled with an agreement by the seller to repurchase the same or substantially identical security at a stated price" and states that "securities owned that are sold by the broker or dealer subject to a repurchase agreement are treated as collateral for financing transactions and not as sales." Banks use the same terminology and account for the transactions in a manner similar to that used by broker-dealers.

Dollar Repurchase–Dollar Reverse Repurchase Agreements

15. Dollar agreements differ from repurchase–reverse repurchase agreements because dollar agreements—

- Are represented by different certificates.
- Are collateralized by different, but similar, mortgage pools, for example, single-family residential mortgages.
- Generally have different principal amounts.

16. Although the AICPA guides and SFAS No. 65 discussed in paragraphs 13 and 14 do not cover dollar agreements specifically, their conclusions appear relevant to dollar repurchase–dollar reverse repurchase agreements. Inherent in the discussions in those guides and SFAS No. 65 is the presumption that the asset (certificate) being "repurchased" is substantially identical in all respects to the asset that was "sold" under the agreement. In a dollar repurchase–dollar reverse repurchase agreement, the certificate that is delivered back may or may not be substantially identical, depending on whether the agreement is a fixed coupon or a yield maintenance dollar agreement.

17. Paragraph 115 of FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises,* states that "to have an asset, a business must control future economic benefit to the extent that it can benefit from the asset and generally can deny or regulate access to that benefit by others. . . ." In a dollar repurchase–dollar reverse repurchase agreement, the degree of control over the future economic benefits relating to the asset (certificate) transferred by the seller-borrower depends on whether the certificate delivered back is substantially identical. If the delivered certificate is not substantially identical to the transferred original, the seller-borrower has surrendered control over the future economic benefits relating to the original certificate and has obtained the right to acquire a different asset.

Seller-Borrower

18. The accounting and reporting treatment for the sale of securities or borrowing of funds under dollar agreements varies in practice. Some account for these agreements by relieving the investment securities account of the certificates sold, currently recognizing gains or losses, and recording the purchase of the newly acquired certificates as a separate transaction. Others account for these agreements as a collateralized financing arrangement. The

certificates involved in the transactions are not removed from the investment securities account, gains or losses are not recognized, and a liability is recorded for the amount of the proceeds.

19. The key factor in distinguishing between the sale and purchase of securities and a financing arrangement is the degree of control over the future economic benefits relating to the certificates transferred by the seller-borrower. If the property repurchased is the identical property sold, the seller-borrower has retained control over the future economic benefits relating to the certificates and has assumed no additional market risk, and the transaction is properly accounted for as a financing arrangement. The seller-borrower in a dollar agreement accepts delivery of certificates that are not identical to the certificates used in originating the transaction. The seller-borrower agrees that the repurchased securities are "substantially identical" to those of the original transaction and therefore are "identical" for purposes of consummating the transaction. Inconsistency in practice in defining "substantially identical" securities and in evaluating risk retention has led to the diversity in accounting for dollar transactions.

20. Those supporting the view that fixed coupon dollar agreements are financing arrangements believe that certificates in the GNMA market having similar collateral and bearing the same interest rate are priced to result in substantially similar market values. The rationale is that GNMA certificate prices or yields are quoted to investors based on an assumption of a certain payment level of the pooled mortgages, which results in similar market values. GNMA prices or yields are not quoted to investors on the basis of yield to contractual maturity, that is, what the investor's return would be if none of the pooled mortgages collateralizing the GNMA certificate was prepaid but paid down in accordance with the contractual amortization schedule. For example, prices or yields of single-family mortgage loan pools are quoted on a basis equivalent to that of a single loan that amortizes according to a prescribed thirty-year amortization schedule with prepayment of the balance in the twelfth year. Although this method does not recognize that different pools of mortgages have varied maturities, it has been accepted and provides a uniform method of quoting prices or yields in the GNMA market.

21. Those supporting the view that fixed coupon dollar agreements are financing arrangements generally agree that fixed coupon

agreements containing a "right of substitution" clause do not involve substantially identical securities because of the inherent uncertainty over the type of securities to be repurchased.[4] Similarly, they also believe that substantially identical securities are not involved if a fixed coupon dollar agreement gives the buyer-lender the option to deliver back to the seller-borrower a certificate having the same coupon rate but priced to result in a significantly different yield, for example, because of differences in payback experience or maturities. In these instances, transactions would be accounted for as the sale and purchase of securities.

22. Those supporting the view that yield maintenance dollar agreements are sell-buy agreements believe that the purchaser is obligated to deliver or sell back only a certificate with a yield agreed on at the time the transaction originated. Therefore, as noted earlier, the delivered or sold back securities may —

- Bear different certificate interest rates.
- Have different investment principal amounts.
- Possess price spread relationships that do not move in tandem with securities sold.
- Be affected by a "par cap."

23. Proponents of sell-buy accounting for yield maintenance agreements also believe the cumulative effect of the differences between the original and repurchased certificates is significant enough to preclude such certificates from being considered substantially identical.

Rollovers and Extensions

24. Occasionally, certificates involved in dollar agreements are not delivered at the settlement date of the agreement. Instead, the contract is extended or rolled over at the request of the purchaser or seller. If the original contract is accounted for as a financing arrangement, some believe that a rollover or extension agreement is a separate economic transaction and should be accounted for independently of the original contract. Others view the rollover or extension as merely a continuation of the original contract and do not treat it as a separate economic event for accounting purposes.

[4]A *right-of-substitution clause* is a provision in dollar repurchase–dollar reverse repurchase agreements permitting the buyer to deliver other than substantially identical securities.

Breakage

25. Certificates repurchased commonly have a principal amount that differs from the principal amount of the certificate originally sold under a dollar agreement. This is referred to as *breakage* and occurs because no two GNMA certificates bear the same principal amount as a result of the monthly amortization of the principal balance of mortgages collateralizing the certificate. It is generally accepted in the marketplace that a "good delivery" (one in accordance with the agreement terms) occurs if the principal amount of the certificates repurchased is within 2.5 percent (plus or minus) of the principal amount of the original certificates. Breakage does not present an accounting practice problem for dollar agreements treated as the sale and purchase of securities. The investment account is reduced by the carrying value of certificates sold and increased by the acquisition cost of the certificates purchased.

26. Accounting practice for breakage varies for dollar agreement transactions considered to be financing arrangements. If the principal amount of the delivered certificates is greater than that of the original certificates, there is general agreement that the excess cost represents an additional investment and should be accounted for accordingly. However, if the principal amount of the repurchased certificates is less, the accounting treatment varies.

27. Some make no entry to reflect the reduction in principal amount. This results in a higher cost being assigned to the smaller principal amount of the delivered certificates.

28. Others reflect the reduction in principal by removing a proportionate share of the original certificates, including the pro rata unamortized original premium (discount), from the accounting records and recognizing any gain or loss. This reduces the investment account to a new cost for the repurchased certificates.

Division's Conclusions

29. The Accounting Standards Division believes that yield maintenance agreements do not involve substantially similar securities. Fixed coupon agreements do involve substantially identical securities for purposes of this statement.[5]

[5]The AICPA Committee on Banking is studying the issues relating to the definition of "substantially the same," and is expected to provide guidance. That guidance should be considered when it is available.

Fixed Coupon

30. Fixed coupon dollar agreements described in this statement of position should be accounted for as collateralized borrowing arrangements (financing) for financial reporting purposes.

31. Accounting for fixed coupon dollar agreements, except as specified in paragraph 32, should be the same as that used for repurchase–reverse repurchase agreements, as described in paragraph 13. A liability should be recorded for the amount of proceeds, and the certificates should not be removed from the accounting records. The difference between selling price and repurchase price should be accounted for as interest cost that is amortized to expense over the term of the agreement and not shown net of interest income. Amortization of original premium (discount) and interest income on the original certificates should continue to be recorded even if there is an exchange of certificates.

32. A fixed coupon agreement that contains a right-of-substitution clause or that provides an option to the buyer-lender to deliver back a certificate priced to result in a significantly different yield should be accounted for in the same manner as a yield maintenance agreement.

Yield Maintenance

33. Yield maintenance dollar agreements should be accounted for as sales with gain or loss recognition[6] and commitments to purchase securities.

34. A sold certificate, including unamortized premium (discount), should be removed from the accounts and gains or losses recognized at the time of sale. The commitment to repurchase should be disclosed in the notes to the financial statements. The newly acquired investment should be recorded at cost at the time of purchase.

Rollovers and Extensions

35. Rollovers and extensions of dollar agreements should be accounted for based on the facts and circumstances at the time of the rollover or extension; for example, the rollover at maturity of a fixed

[6]If the market value of the securities sold differs from the contract price, the gain or loss should be recognized based on the market value.

coupon dollar agreement into another fixed coupon dollar agreement should be accounted for as a financing arrangement. However, when a fixed coupon dollar agreement is rolled over into another fixed coupon dollar agreement with the same coupon rate at a number of successive maturity dates, or when the period of time from initiation to close is lengthy, for example, more than one year, the seller-borrower may not be receiving the risks and opportunities of ownership of a security substantially identical to that of the original security. These transactions should be accounted for as the completion of a financing arrangement resulting in a sale with gain or loss recognition[7] and a commitment to purchase securities. The rollover at maturity of a fixed coupon dollar agreement into a yield maintenance dollar agreement results in a new contract. The fixed coupon agreement should be accounted for as the completion of a financing arrangement, and the rollover into a new yield maintenance agreement should be accounted for as a sale with gain or loss recognition[8] and a commitment to purchase securities.

Breakage

36. If the principal amount of the certificate repurchased in a fixed coupon transaction (financing) is greater than that of those originally sold, the difference should be recorded in the investment account as though a separate acquisition of additional certificates has occurred. If the principal amount is less, the investment account should be relieved of the proportionate share of certificates that have been sold, and gains or losses adjusted for the pro rata share of unamortized premium (discount), should be recognized.

37. Examples of the accounting for dollar agreements are included in the Appendix of this statement.

Effective Date and Transition

38. The conclusions of this statement of position should be applied prospectively to transactions entered into after December 31, 1984. Earlier application is encouraged.

[7]See note 6.

[8]See note 6.

APPENDIX

Examples of Accounting for Dollar Agreements

Fixed Coupon

Accounting by Seller-Borrower

Facts

A financial institution owns an 8 percent GNMA pass-through certificate, pool no. 12345, purchased at 100 (face amount) during November 1977. It agrees to sell this certificate (face amount of $987,436) on January 15, 1980, at its market value (80) and concurrently agrees to repurchase on May 13, 1980, an 8 percent GNMA pass-through certificate (face amount of $987,436) at a price of $80^{27}/_{32}$. The seller and buyer agree that "good delivery" of the 8 percent GNMAs on the repurchase date will occur if the principal amount is within 2.5 percent (plus or minus) of the $987,436. For the sake of simplicity, this example assumes no pay-down of principal.

<u>*January 15, 1980*</u>

Cash	$ 793,021	
Interest income on investment in GNMA ($987,436 × 8% × $^{14}/_{360}$)		$ 3,072
Funds borrowed ($987,436 × 80)		789,949

To record amounts received under dollar agreement and interest earned from January 1, 1980, to January 15, 1980.

<u>Summary of Monthly Journal Entries Recorded During the 120-Day Agreement Period</u>

Interest expense on funds borrowed ($987,436 × 8% × $^{120}/_{360}$)	$ 26,332	
Interest income on investment in GNMA		$ 26,332

To record normal interest income/expense on 8% GNMA sold under dollar agreement.

Interest expense on funds borrowed [$987,436 × ($80^{27}/_{32}$ − 80)]	$ 8,331	
Accrued interest payable		$ 8,331

To record differential in price as additional interest expense.

May 13, 1980

Assumption A

Assume return of an 8 percent GNMA pass-through certificate, pool no. 23451, with a current face amount of $1,004,878 (within the 2.5 percent range for "good delivery"), which is greater than the original principal amount.

Investment in 8% GNMA, pool no. 23451 (new), $987,436 + [($1,004,878 − $987,436) × $80^{27}/_{32}$]	$1,001,537	
Accrued interest receivable ($1,004,878 × 8% × $^{12}/_{360}$)	2,680	
Investment in 8% GNMA, pool no. 12345 (old)		$987,436
Cash (increment in certificate basis) [($14,101) + interest ($2,680)]		16,781

To record additional principal of 8% GNMA, pool no. 23451, and interest earned from May 1, 1980, to May 13, 1980.

Funds borrowed	$ 789,949	
Accrued interest payable	8,331	
Cash		$798,280

To record repayment of funds borrowed.

Assumption B

Assume return of an 8 percent GNMA pass-through certificate, pool no. 23452, with a current face amount of $972,625 (within the 2.5 percent range for "good delivery"), which is less than the original principal amount.

Investment in 8% GNMA, pool no. 23452 (new)	$972,625	
Accrued interest receivable ($972,625 × 8% × $^{12}/_{360}$)	2,594	
Loss on sale of investment in GNMA, 8% pool no. 12345 [$14,811 × (100 − 80)]	2,962	
Funds borrowed	14,811	
Accrued interest payable [14,811 × ($80^{27}/_{32}$ − 80)]	124	
Interest income on GNMA investment ($14,811 × 8% × $^{120}/_{360}$)	396	
Investment in 8% GNMA, pool no. 12345 (old)		$987,436
Interest expense on funds borrowed ($124 + $396)		520
Cash		5,556

To record purchase of 8% GNMA, pool no. 23452, sale of 8% GNMA, pool no. 12345, and reduction of funds borrowed on January 15, 1980.

Note: The reduction in basis ($987,436 − $972,625 = $14,811) between the old certificate and the new certificate is used to determine the amount of loss recognition and to adjust the following accounts: funds borrowed, accrued interest, and interest income as established on January 15, 1980, and during the 120-day period ended May 13, 1980.

Funds borrowed ($789,949 − $14,811)	$775,138	
Accrued interest payable ($8,331 − $124)	8,207	
Cash		$783,345

To record repayment of funds borrowed.

Summary of Cost of Borrowed Funds

Assumption A

Interest on 8% GNMA, pool no. 12345	$ 26,332
Difference between sale and repurchase price ($80^{27}/_{32}$ − 80)	8,331
Total cost of funds	$ 34,663
Borrowed funds	$789,949

$$\frac{\text{Cost of Funds (\$ 34,663)}}{\text{Borrowed Funds (\$789,949)}} = .044 \times 3 = 13.2\% \text{ annualized}$$

Assumption B

Interest on 8% GNMA, pool no. 12345	$ 26,332
Difference between sale and repurchase price ($80^{27}/_{32}$ − 80)	8,331
Interest expense adjustment due to reduction in basis	(520)
Total cost of funds	$ 34,143
Initial borrowed funds	$789,949
Less partial sale of 8% GNMA, pool no. 12345	14,811
Actual borrowed funds	$775,138

$$\frac{\text{Cost of Funds (\$ 34,143)}}{\text{Borrowed Funds (\$775,138)}} = .044 \times 3 = 13.2\% \text{ annualized}$$

Yield Maintenance

Accounting by Seller-Borrower

Facts

A financial institution owns a 9.5 percent GNMA pass-through certificate, pool no. 34621, purchased at 97 during August 1979. It agrees to sell this certificate (face amount of $992,925) on January 15, 1980, at its market value ($86^{22}/_{32}$) and concurrently agrees to repurchase a 9.5 percent GNMA pass-through certificate (face amount of $992,925) on May 13, 1980, at 88 to yield 11.34 percent. The seller and buyer agree that "good delivery" of the GNMAs on the repurchase date will occur if the principal amount is within 2.5 percent (plus or minus) of the $992,925. They further agree that if the FHA or VA mortgage rate changes during the four-month period, the buyer may deliver on the repurchase date a GNMA pass-through certificate bearing the new current interest rate at a price to produce the above yield of 11.34 percent; however, such price shall not exceed par (yield maintenance agreement with a par cap). For the sake of simplicity, this example assumes no pay-down of principal.

January 15, 1980

Cash	$864,410	
Loss on sale of investment in 9.5% GNMA, pool no. 34621	102,395	
Unearned discount	29,788	
Investment in 9.5% GNMA, pool no. 34621		$992,925
Interest income on investment in GNMA ($992,925 × 9.5% × $^{14}/_{360}$)		3,668

To record sale of 9.5% GNMA, pool no. 34621, in connection with yield maintenance agreement and interest earned from January 1, 1980, to January 15, 1980.

Note:

Face amount	$992,925
Cost (97)	963,137
Unearned discount	$ 29,788
Market January 15, 1980 ($992,925 × $86^{22}/_{32}$)	$860,742
Loss ($963,137 − $860,742)	$102,395

May 13, 1980

Assumption A

Assume the FHA or VA mortgage rate did not change during the four-month period of the agreement and a 9.5 percent GNMA pass-through certificate, pool no. 18960, with a current face amount of $989,650 (within the 2.5 percent range for "good delivery") is delivered to the seller-borrower.

Investment in 9.5% GNMA, pool no. 18960		
($989,650 × 88)	$870,892	
Accrued interest receivable		
($989,650 × 9.5% × 12/360)	3,133	
Cash		$874,025

To record purchase of 9.5% GNMA, pool no. 18960, and accrued interest from May 1, 1980, to May 13, 1980.

Assumption B

Assume the FHA or VA mortgage rate did change during the four-month period of the agreement and delivery is made with an 11 percent (current GNMA interest rate) GNMA pass-through certificate, pool no. 48650, with a current face amount of $998,875 (within the 2.5 percent range for "good delivery") priced at $97\frac{12}{32}$ to provide the agreed yield of 11.34 percent.

Investment in 11% GNMA, pool no. 48650		
($998,875 × $97\frac{12}{32}$)	$972,655	
Accrued interest receivable		
($998,875 × 11% × 12/360)	3,662	
Cash		$976,317

To record purchase of 11% GNMA, pool no. 48650, and accrued interest from May 1, 1980, to May 13, 1980.

Rollover or Extension

Facts

A financial institution entered a four-month fixed coupon agreement from January 15, 1980, to May 13, 1980. On May 13, 1980, the institution repurchased an 8 percent GNMA pass-through certificate, pool no. 23451, with a face amount of $1,004,878 and a book basis of $1,001,537. The institution accounted for the transaction as a financing and recorded journal entries in the manner previously described in this Appendix. Also on May 13, 1980, the institution agrees to sell certificate no. 23451 at its market value (81) and agrees to repurchase an 8 percent GNMA pass-through certificate (current face amount of $1,004,878) three months later (ninety days) on August 10, 1980.

May 13, 1980

Assumption A — Financing Transaction

Assume a fixed coupon agreement from May 13, 1980, to August 10, 1980.

Cash	$816,631	
Accrued interest receivable ($1,004,878 × 8% × 12/360)		$ 2,680
Funds borrowed ($1,004,878 × 81)		813,951

To record amounts received under fixed coupon agreement, 8% GNMA, pool no. 23451, from May 13, 1980, to August 10, 1980, and interest received for the period May 1, 1980, to May 13, 1980.

Assumption B — Sell-Buy

Assume a yield maintenance agreement from May 13, 1980, to August 10, 1980.

Cash	$816,631	
Loss on sale of investment in 8% GNMA, pool no. 23451 [$1,001,537 − ($1,004,878 × 81)]	187,586	
Investment in 8% GNMA, pool no. 23451		$1,001,537
Accrued interest receivable		2,680

To record sale of 8% GNMA, pool no. 23451, in connection with yield maintenance agreement from May 13, 1980, to August 10, 1980, and interest received for the period May 1, 1980, to May 13, 1980.

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